Malta Maritime Law Association Seminar on

Developing Trends in Ship Finance

Ship Finance – Traditional Models
Ivan Vella, Vella Advocates

Ever since the evolution of larger ships (especially but not exclusively oil and gas tankers) the shipping industry has experienced a repeated tendency towards highly geared capital structures. This has led to at least three major shipping crises – that in the late 1960s, another in the mid1970s, yet another one in the 1980s, and the last one almost decade ago (and which is still with us)

The larger the ships the greater the costs of acquisition and operation thereof; and hence the greater need for external finance (which inevitably leads to higher financing costs)

Ship finance is the finance of activities relating to ships and shipping (the ownership and, or operation of ships) where the ship is a central figure, both as the 'object' (directly or indirectly) of the finance transaction and, very frequently, as the principal or one of the main items of security in the transaction

Traditional ship finance has been described as 'a specialized form of medium-term bank lending'

Historically, this type of ship finance is fundamentally … asset-based and asset-backed (asset finance)

What led to these crises … some common factors may be outlined:

- a bullish shipping market (generally fuelled by increased demand in international trade flows)
- a high/disproportionate cost of tonnage (in relation to earnings/potential earnings)
- imprudent lending policies and decisions
- severely high gearing within ship owning groups and entities
- a tonnage glut (surplus of tonnage over demand)
- a sudden devaluation of asset value
- primary market shock or outright collapse (freight and hire rates)
- borrowers' inability to service debt
- the widespread sale/liquidation/realization of distressed assets used as security

As a result … banks' ship finance portfolios are razed to the ground and banks become reluctant to take a fresh plunge into the ship finance pool resulting in a dearth of available liquidity for ship owners and operators to tap into!

Nowadays this absence of liquidity is further exacerbated by the notable absence of export credit agencies (that support ship builders)

Also by the fact that most institutional ship finance providers are based in Europe and in Japan, economies that have borne the brunt of the last global economic crisis

Why do we need ship finance in the first place?

a) the financing of the acquisition of tonnage;
b) the financing of the operation of tonnage.

Who provides finance?

(i) the owners' own funds;
(ii) ***institutional financiers*** (credit and financial institutions);
(iii) capital markets (IPOs, bonds etc);
(iv) investment funds;
(v) AIFs;
(vi) private equity;
(vii) securitization vehicles;
(viii) family offices;
(ix) venture capitalists;
(x) wealthy individuals.

Broadly speaking three forms/sources/types of ship finance may be identified …

1) Asset Finance: the main purpose of the finance is the acquisition or operation of one or more assets (ships)

2) Corporate Finance: the main purpose is to inject liquidity into the borrower/the wider group of companies to which the borrower belongs in an attempt (albeit indirectly) to strengthen the borrower's (and, or its wider group of companies') balance sheet

3) Equity Finance:

- ordinary equity (entailing voting rights, rights to dividends, rights to appoint directors etc)
- other equity (usually preference shares etc)
- mezzanine finance

As previously noted the traditional model for ship finance transactions has historically been in the form of asset finance. Nevertheless over the past years it can be best described as *a hybrid of asset and corporate finance* – not least because account is taken of and emphasis

placed on the overall financial situation of the borrower and the wider group of companies to which the borrower belongs

Asset finance provided by institutional financiers (commonly referred to as 'Senior Debt' or 'Unsubordinated Debt')

Purpose: EITHER the acquisition of tonnage (new or second-hand) OR the financing of shipping operations OR towards improving the ship owner/ship operator's working capital OR towards conversion or major repair works OR re-financing existing facilities OR other specific purposes relating to one or more ships

Structure: usually EITHER a term facility OR a revolving facility

Key feature/characteristic: secured *inter alia* by real security over one or more ships being the 'object' of the finance transaction. The debt servicing therefore hinges on the ships being operated continuously, efficiently, profitably etc. The ship must continue to be operated by its owner/designated operator (the owner or an approved charterer or manager) and remains in the possession of such party

Lender's risks: These are some of the principal risks that a lender would usually evaluate, further a request for ship finance, in assessing whether or not to grant a facility and, in the affirmative, the cost or pricing or rate of return at which it would be prepared to do so –

(i) credit default risk (customer's solvency, history and credit rating of applicable);
(ii) market/structural risk (overall assessment of world trade, costs of bunkers, costs of labour, geopolitical issues, specific issues depending on the type of ship and geographical scope of activity, if applicable);
(iii) counter-party risk (spill-over);
(iv) risk of asset value impairment (LTMV ratios); - [this remains a key factor/consideration]
(v) risk of increased cost of borrowing;
(vi) risk of erosion in real value of return (interest payments);
(vii) risk of arrest or detention of the secured assets;
(viii) risk of loss of the secured assets (which is usually an insurable risk)

Documentation: Facility Agreement (creating the underlying principal obligations of repayment etc) + Security Documents

Based on a previously negotiated indicative term sheet or LOI or similar document

- Definitions
- Commitment
- Purpose
- Availability period
- Borrower's and security parties' warranties and representations
- Conditions for drawdown (CPs) and drawdown mechanics

- Payment of interest (usually based on LIBOR for 1, 3 or 6-month periods + a margin) and interest periods
- Repayment and prepayments
- Borrower's positive and negative covenants: (i) financial; (ii) technical/operational; and (iii) reporting
- Insurance undertakings
- Environmental undertakings
- Increased cost (including breakage costs) and the consequences thereof
- Asset protection (Loan to Market Value Ratios) and the consequences of breach thereof
- Regulatory restrictions imposed upon the Lender, for instance liquidity and own funds ratios (by measures such as Basel II and Basel III) and the consequences thereof
- Events of default and the consequences thereof
- Transfer and syndication provisions (where applicable)
- Governing law and dispute settlement provisions
- Miscellaneous provisions (providing for notice etc)

Security and related documentation: a *sine qua non* accompaniment to traditional ship finance transactions. Typically security will include one or more of the following:

(i) Guarantees (corporate and collateral)
(ii) Mortgages (real security) on ships and related deeds of covenants
(iii) Assignments of earnings
(iv) Assignments of rights under contracts of insurance (and P&I)
(v) Pledges or other charges over shares/securities
(vi) Pledges or other charges of earnings accounts

It is also not infrequent to come across cross-collateralized security

Traditional lenders have also ventured into more exotic forms of finance including *structured finance transactions* (using tools such as put options, call options, financial derivatives etc) and, or *securitization* (where a debt is secured by collateral, typically real rights over assets, for which the borrower is not personally liable so that if and when the borrower defaults the lender can only seize the collateral, in other words without a right of recourse against the borrower/debtor)

Drawing some conclusions …

The shipping community has still not fully recovered from its most recent crash (that started in 2008). The numbers show that although there are signs of optimism the greater part of the industry is still in convalescence

Commercial banks, specialized ship finance banks and other credit and financial institutions are still by-and-large reluctant to provide ship finance, except perhaps to re-finance existing indebtedness owed by long-standing customers

Even so the tide is likely to turn in the not too distant future and traditional ship finance models may yet be on the ascendant. Three factors appear to point towards this conclusion:

First, history and experience have taught us that shipping and ship finance (like almost everything else in life) follow well-defined cycles (as opposed to straight-line trajectories)

Second, there is ample excess liquidity in the global economy and, more importantly, in the treasuries of several credit and financial institutions

Third, the early-morning signs appear to disclose an 'untightening' of restrictions in US and European banks

If I were a soothsayer I would predict that by the mid-2020s traditional ship finance models will be back at the forefront